Quadrant II - Notes

Programme: Bachelor of Arts (Third Year)

Subject: Economics

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Paper Title: Public Finance - I

Unit: IV Budgetary Process

Module Name: Concept of Fiscal Imbalance: Revenue, Fiscal, Primary and Budgetary Deficits

Module No: 26

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Fiscal imbalance

Fiscal imbalance is a **mismatch** in the revenue powers and expenditure responsibilities of a government.

When the revenue powers are divided between two or more tiers of government in a federation (i.e., center, state, local). In general, the Central government is entrusted with more financial resources.

This is because due to its functional responsibilities like defense, space research, pension etc.

There is always a greater demand for its expenditure requirement than its revenue resources.

That can lead to **Fiscal crisis** where the government expenditure is much higher than government revenue.

Types of Fiscal Imbalance

1. **Vertical Fiscal Imbalance**

   When the fiscal imbalance is measured between the two levels of government (Center and States or Provinces) it is called **Vertical Fiscal Imbalance**.

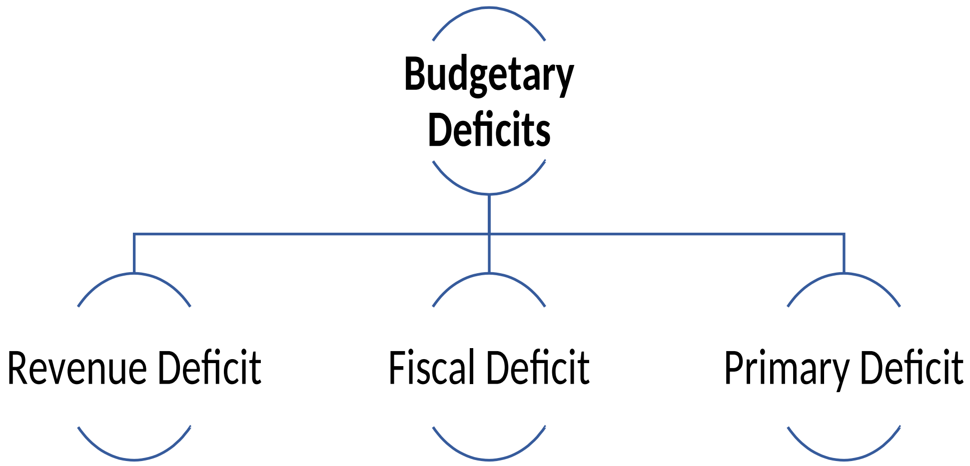
2. **Horizontal Fiscal Imbalance.**

   When the fiscal imbalance is measured between the governments at the same level it is called **Horizontal Fiscal imbalance**.

   This imbalance is also known as **regional disparity.**

Budgetary Deficits

- Budgetary deficit is the **excess** of total expenditure (both revenue and capital) over total receipts (both revenue and capital).
- There are **three** types of budgetary deficits.



1. **Revenue Deficit**

Revenue deficit is excess of total revenue expenditure of the government over its total revenue receipts.

Revenue deficit signifies that government's own earning is insufficient to meet normal functioning of government departments and provision of services. Revenue deficit results in borrowing.

Symbolically:

Revenue deficit = Total Revenue expenditure – Total Revenue receipts

2. **Fiscal Deficit**

Fiscal deficit is defined as excess of total budget expenditure over total budget receipts excluding borrowings during a fiscal year.

In simple words, it is amount of borrowing the government has to resort to meet its expenses.

A large deficit means a large amount of borrowing.

Fiscal deficit is a measure of how much the government needs to borrow from the market to meet its expenditure when its resources are inadequate.

Symbolically:

Fiscal deficit = Total Expenditure – Revenue receipts – Capital receipts excluding borrowing

Fiscal deficit is, in fact, equal to borrowings. Thus, fiscal deficit gives the borrowing requirement of the government.

Fiscal deficit = Total expenditure – Total receipts excluding borrowings = Borrowing

Importance:

Fiscal deficit shows the borrowing requirements of the government during the budget year.

Greater fiscal deficit implies greater borrowing by the government.

The extent of fiscal deficit indicates the amount of expenditure for which the government has to borrow money.

3. **Primary Deficit**

Primary deficit is defined as fiscal deficit of current year minus interest payments on previous borrowings.

In other words, whereas fiscal deficit indicates borrowing requirement inclusive of interest payment, primary deficit indicates borrowing requirement exclusive of interest payment (i.e., amount of loan).

Borrowing requirement of the government includes not only accumulated debt, but also interest payment on debt.

If we deduct ‘interest payment on debt’ from borrowing, the balance is called primary deficit.

To know the amount of borrowing on account of current expenditure over revenue, we need to calculate primary deficit.

Zero primary deficits means that government has to resort to borrowing only to make interest payments.

Thus, primary deficit is equal to fiscal deficit less interest payments.

Symbolically:

Primary deficit = Fiscal deficit – Interest payments

Summary

Fiscal imbalance is a **mismatch** in the revenue powers and expenditure responsibilities of a government.

Budgetary deficit is the **excess** of total expenditure (both revenue and capital) over total receipts (both revenue and capital).

There are **three** types of budgetary deficits.

Revenue deficit = Total Revenue expenditure – Total Revenue receipts

Primary deficit = Fiscal deficit – Interest payments

Fiscal deficit = Total Expenditure – Revenue receipts – Capital receipts excluding borrowing